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In the Supreme Court of the United States

OCTOBER TERM, 1941

GUY T. HELVERING, COMMISSIONER OF INTERNAL REVENUE, PETITIONER

v.

R. A. SPROUSE

PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES CIRCUIT COURT OF APPEALS FOR THE NINTH CIRCUIT

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The Solicitor General, on behalf of Guy T. Helvering, Commissioner of Internal Revenue, prays that a writ of certiorari issue to review the judgment of the Circuit Court of Appeals for the Ninth Circuit entered in the above case on October 22, 1941, reversing the decision of the United States Board of Tax Appeals.

OPINIONS BELOW

The findings and opinion of the Board of Tax Appeals (R. 19–33) are reported at 42 B. T. A.

484. The opinion of the Circuit Court of Appeals (R. 50) is reported at 122 F. (2d) 973.

JURISDICTION

The judgment of the Circuit Court of Appeals was entered on October 22, 1941 (R. 55). The jurisdiction of this Court is invoked under Section 240 (a) of the Judicial Code, as amended by the Act of February 13, 1925.

QUESTION PRESENTED

Whether the owner of voting common stock of a corporation realized taxable income upon the receipt of a stock dividend paid in nonvoting common stock of the corporation.

CONSTITUTIONAL PROVISIONS, STATUTE, AND REGULATIONS INVOLVED

The constitutional provisions, statute and regulations involved are set forth in the Appendix, *infra*, pp. 12–17.

STATEMENT

The facts, as stipulated (R. 12–19) and as found by the Board (R. 21–25), may be summarized as follows:

The respondent, R. A. Sprouse, was the owner of voting common stock in Sprouse-Reitz Company, Inc., an Oregon corporation, which, on February 13, 1936, paid a 10 percent stock dividend in new shares of its nonvoting common stock. (R. 12, 14, 21, 22.) The corporation had outstanding only two classes of

stock, voting and nonvoting common stock having par values in the respective aggregate amounts of $397,471.25 and $819,333.06.[1] (R. 13, 21.) The stock dividend consisted of $121,680.43 par value nonvoting common stock which was distributed to the holders of both the voting and nonvoting common in proportion to their respective stockholdings.[2] (R. 14, 15, 22, 23.) The fair market value of the nonvoting common stock at the time of distribution was equal to its par value. (R. 15, 23.)

The earnings and profits of the corporation available for distribution at the time of the dividend were not less than $200,000.[3] (R. 15.)

The respondent received 200 shares of the nonvoting common stock having a fair market value of

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[1] The corporation had authorized capital stock of $2,000,000, consisting of 6,000 shares of voting common, 12,000 shares of nonvoting common, and 2,000 shares of nonvoting preferred stock, the shares of each class having a par value of $100 each (R. 13, 21).

[2] Although Finding 5 (R. 23) states that the distribution was "in proportion" to the respective stockholdings of both classes, Finding 3 (R. 22) gives specific figures that are slightly at variance with that conclusion. Thus, pursuant to Finding 3, the voting common received a $40,333.34 dividend in nonvoting common and the nonvoting common received an $81,347.09 dividend in nonvoting common. However, the Government concedes, for the purpose of this case, that the statement in Finding 5 is correct.

[3] On the same day that it paid the $121,680.43 stock dividend, February 13, 1936, the corporation also paid a 6% cash dividend in the aggregate amount of $73,008.26, which was distributed among the holders of both classes of stock (R. 14).

$20,000 as his share of the distribution. (R. 15, 17, 23, 24.) Prior to the dividend, he did not own any nonvoting common. (R. 12, 21.) In his 1936 income tax returns, he did not report any income on account of that dividend. The Commissioner determined a deficiency by including the value of the stock dividend as income, and the Board of Tax Appeals sustained the determination.[4] (R. 19–33.) The Circuit Court of Appeals reversed, holding that the stock dividend could not constitutionally be subjected to tax if it were distributed to holders of both classes of outstanding stock in proportion to their stockholdings.

SPECIFICATION OF ERRORS TO BE URGED

The Circuit Court of Appeals erred:

1. In holding that the stock dividend could not constitutionally be subjected to tax.

2. In holding that the nonvoting common stock which taxpayer received as a dividend upon his voting common stock was not income to the taxpayer.

3. In failing to hold that taxpayer realized income in the amount of the fair market value of

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[4] The corporation also paid a dividend in nonvoting preferred stock on its voting and on its nonvoting common stock in December 1936 (R. 14–15, 22). In this distribution taxpayer received preferred stock of a par and a market value of $22,300 (R. 15, 17, 23, 24). The Commissioner treated this stock dividend as taxable, and the Board also upheld this part of the Commissioner's determination. Upon appeal to the court below the taxpayer did not challenge this part of the Board's decision.

the shares of nonvoting common stock which he received as a stock dividend upon his shares of voting common stock.

4. In reversing the decision of the Board of Tax Appeals.

REASONS FOR GRANTING THE WRIT

1. The decision below rests upon *Eisner* v. *Macomber*, 252 U. S. 189, which held that Congress had no authority under the Constitution to impose a tax upon a dividend of common stock paid to the shareholders of a corporation which had only common stock outstanding. *Eisner* v. *Macomber* was decided by a sharply divided court, and established erroneous constitutional limitations upon the Federal taxing power. That decision has been a source of considerable confusion, and has stood with its sweeping exposition of the constitutional limits upon the taxing power as an obstacle to the formulation of sound revenue legislation. It is of public importance that *Eisner* v. *Macomber* be reexamined, not merely because of its erroneous ruling with respect to the taxation of stock dividends, but, more important, because of its restrictive effect upon tax law generally.

The basic power of Congress to levy taxes is conferred by Article I, Section 8, Clause 1 of the Constitution, which provides:

> The Congress shall have power to lay and collect taxes, duties, imposts, and excises, to pay the debts and provide for the common

> defense and general welfare of the United States; but all duties, imposts, and excises shall be uniform throughout the United States;

The authority so conferred "is exhaustive and embraces every conceivable power of taxation." *Brushaber* v. *Union Pac. R.R.*, 240 U. S. 1, 12. The Constitution itself imposes but three restrictions upon the exercise of that power: (1) duties, imposts, and excises must be uniform throughout the United States (Art. I, Sec. 8, cl. 1); (2) direct taxes must be apportioned among the states according to population (Art. I, Sec. 2, cl. 3, and Art. I, Sec. 9, cl. 4); and (3) no tax or duty may be laid upon exports (Art. I, Sec. 9, cl. 5).

Apart from the foregoing restrictions the power to tax is plenary. However, it was held in *Pollock* v. *Farmers' Loan & Trust Co.*, 157 U. S. 429, 158 U. S. 601, that a tax upon income from property is a direct tax, and is therefore invalid unless apportioned among the states according to population.

The Sixteenth Amendment to the Constitution was adopted in response to the *Pollock* decision, and provides:

> The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

The Amendment was not intended as a limitation upon the taxing power. Rather, it was intended to *expand* the taxing power, giving full scope to Congressional power under Article I, unencumbered by the unworkable requirement of apportionment which the majority of the Court thought existed in the *Pollock* case with respect to certain types of income.

No one has ever doubted that stock dividends could be taxed under the plenary power granted by Article I, the only question being whether a tax upon stock dividends must be apportioned. We submit that whatever basis there may have been for the apportionment requirement has been removed by the Sixteenth Amendment which was intended "to get rid of nice questions as to what might be direct taxes" (Holmes J., dissenting in *Eisner* v. *Macomber*, 252 U. S. at 220).

The *Macomber* decision erroneously treats the Sixteenth Amendment as though it were the source of the taxing power and undertakes to measure the tax by what it conceives to be limitations imposed by the Amendment. It is a matter of great public importance that this Court clarify the scope of the taxing power so as to accord to Congress the full sweep of authority that was intended by Article I and the Sixteenth Amendment.

As frequently happens in the case of unsound decisions, the operative scope of *Eisner* v. *Macomber* has been considerably narrowed by subse-

quent decisions. See *United States* v. *Phellis*, 257 U. S. 156; *Rockefeller* v. *United States*, 257 U. S. 176; *Cullinan* v. *Walker*, 262 U. S. 134; *Marr* v. *United States*, 268 U. S. 536; *Koshland* v. *Helvering*, 298 U. S. 441; *Helvering* v. *Gowran*, 302 U. S. 238; *Helvering* v. *Braun*, 309 U. S. 461, 468. The process of increasing limitation upon *Eisner* v. *Macomber* has now reached the point where it has become exceedingly difficult to reconcile the basic theory of that case with the later expressions of this Court.

But the process of distinguishing *Eisner* v. *Macomber* has been an unsatisfactory method of dealing with the problem. The decision has continued to cast a restrictive influence upon the legislative development of an effective method for taxing corporate earnings; witness the undistributed profits

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Illustrative of the confusion produced by the *Macomber* case is the fact that Congress thereafter specifically exempted all stock dividends from tax, thinking that such sweeping exemption was constitutionally required by the decision. See *Koshland* v. *Helvering*, 298 U. S. at 444–445. It was not until after the *Koshland* decision, some fifteen or sixteen years after *Eisner* v. *Macomber*, that Congress, in Section 115 (f) of the Revenue Act of 1936 (see Appendix, *infra*), eliminated that exemption and substituted a provision which in effect makes taxability coextensive with constitutional powers, thereby throwing back upon the courts the question of how far the *Macomber* case goes.

tax under the Revenue Act of 1936.* And the present national emergency requires that Congress be free to develop fiscal policies unhampered by Constitutional limitations of such doubtful validity.

2. Even if *Eisner* v. *Macomber* be permitted to stand, the decision below conflicts in principle with *Koshland* v. *Helvering*, 298 U. S. 441. Underlying the *Koshland* decision was the holding that a distribution of a dividend in common stock to holders of preferred stock constituted taxable income in the hands of the recipients. The Court pointed out that "where a stock dividend gives the stockholder an interest different from that which his former stockholdings represented he receives income." 298 U. S. at 446. Applying that principle here, it is apparent that the respondent, who owned only voting stock prior to the dividend, thereafter became the owner of non-voting as well as voting

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*Compare the provisions of Section 337 of the Internal Revenue Code relating to foreign personal holding companies, where Congress has undertaken to tax corporate earnings directly to the stockholder in order to prevent avoidance. Conceivably, if Congress were freed of the restrictive effect of *Eisner* v. *Macomber*, it might adopt the same method of taxing earnings of domestic corporations. Cf. *Collector* v. *Hubbard*, 12 Wall. 1.

stock. There had been a readjustment of corporate structure, such that respondent could sell his non-voting stock and still retain the same control over the enterprise. The non-voting stock distributed to him represented corporate earnings, convertible into cash by sale without diminishing his basic interest any more than would have been the situation in the *Koshland* case had the stockholder sold the stock dividend.

3. The decision below is in conflict with the decision of the Circuit Court of Appeals for the Second Circuit in *Strassburger* v. *Commissioner of Internal Revenue*, decided December 22, 1941, not yet officially reported but which may be found in 1941 Prentice Hall, Vol. 4, Par. 63,103. There the owner of all the common stock of a corporation, which had only common stock outstanding, received a stock dividend of non-voting, cumulative, seven percent preferred stock. The Court held that the stock dividend was taxable. Although the facts in the two cases are not identical, there is an essential conflict in basic theory between the decisions. The difference between the courts stems from varying interpretations of the scope of the *Koshland* v. *Helvering* and *Eisner* v. *Macomber*. In the *Koshland* case this Court summarized the rules as follows (pp. 445–446):

> Under our decisions the payment of a dividend of new common shares, conferring no different rights or interests than did the old,—the new certificates, plus the old, repre-

> senting the same proportionate interest in the net assets of the corporation as did the old,—does not constitute the receipt of income by the stockholder. On the other hand, where a stock dividend gives the stockholder an interest different from that which his former stock holdings represented he receives income. * * *

It is to be noted that the tests laid down by these two sentences are not mutually exclusive since it is possible for a stock dividend to result in giving the stockholder an interest different from that which his former holdings represented and yet not change his proportionate interest in the net assets of the corporation. Both the instant case and the *Strassburger* case are examples of such a situation. The Second Circuit held in the *Strassburger* case that since the new stock represented interests different from those which the old stock represented it constituted income, even though the stockholder's fractional interest in the net assets of the corporation was not changed. In the instant case the court below stated that in its opinion the "real test" is "whether the distribution effects a change in the proportionate interests of the stockholders."

CONCLUSION

It is respectfully submitted that the within petition should be granted.

CHARLES FAHY,
Solicitor General.

JANUARY 1942.

APPENDIX

Constitution of the United States:

Article I, Section 2, clause 3:

Representatives and direct Taxes shall be apportioned among the several States which may be included within this Union, according to their respective Numbers, which shall be determined by adding to the whole Number of free Persons, including those bound to Service for a Term of Years, and excluding Indians not taxed, three-fifths of all other Persons * * *.

Article I, Section 8, clause 1:

The Congress shall have Power To lay and collect Taxes, Duties, Imposts and Excises, to pay the Debts and provide for the common Defence and general Welfare of the United States; but all Duties, Imposts and Excises shall be uniform throughout the United States * * *.

Article I, Section 9, clauses 4 and 5:

No Capitation, or other direct, Tax shall be laid, unless in Proportion to the Census or Enumeration herein before directed to be taken.

No Tax or Duty shall be laid on Articles exported from any State.

* * * * *

Sixteenth Amendment:

The Congress shall have power to lay and collect taxes on incomes, from whatever source derived, without apportionment among the several States, and without regard to any census or enumeration.

Revenue Act of 1936, c. 690, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) *General Definition.*—"Gross income" includes gains, profits, and income derived from * * * dividends, * * *.

* * * * *

SEC. 115. DISTRIBUTIONS BY CORPORATIONS.

(a) *Definition of Dividend.*—The term "dividend" when used in this title * * * means any distribution made by a corporation to its shareholders, whether in money or in other property, (1) out of its earnings or profits accumulated after February 28, 1913, or (2) out of the earnings or profits of the taxable year (computed as of the close of the taxable year without diminution by reason of any distributions made during the taxable year), without regard to the amount of the earnings and profits at the time the distribution was made.

(b) *Source of Distributions.*—For the purposes of this Act every distribution is made out of earnings or profits to the extent thereof, and from the most recently accumulated earnings or profits. * * *

* * * * *

(f) *Stock Dividends.*—

(1) *General Rule.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall not be treated as a dividend to the extent that it does not constitute income to the shareholder within the meaning of the Sixteenth Amendment to the Constitution.

(2) *Election of shareholders as to medium of payment.*—Whenever a distribution by a

corporation is, at the election of any of the shareholders (whether exercised before or after the declaration thereof), payable either (A) in its stock or in rights to acquire its stock, of a class which if distributed without election would be exempt from tax under paragraph (1), or (B) in money or any other property (including its stock or in rights to acquire its stock, of a class which if distributed without election would not be exempt from tax under paragraph (1)), then the distribution shall constitute a taxable dividend in the hands of all shareholders, regardless of the medium in which paid.

* * * * * *

Treasury Regulations 94, relating to the Revenue Act of 1936:

ART. 115–4. *Stock dividends.*—A distribution made by a corporation to its shareholders in its stock or in rights to acquire its stock shall be treated as a dividend to the full extent that it constitutes income to the shareholders within the meaning of the sixteenth amendment to the Constitution. The Supreme Court has pointed out some of the characteristics distinguishing a stock dividend which constitutes income from one which does not constitute income within the meaning of the Constitution.[1] The distinction between a stock dividend which does not,

[1] See *Eisner* v. *Macomber* (252 U. S. 189, T. D. 3010, C. B. 3, 25); and *Koshland* v. *Helvering* (56 Sup. Ct. 767, Ct. D. 1124, C. B. XV–1, 219). Compare *United States* v. *Phellis* (257 U. S. 156, T. D. 3270, C. B. 5, 37); *Rockefeller* v. *United States* (257 U. S. 176, T. D. 3271, C. B. 5, 34); *Cullinan* v. *Walker* (262 U. S. 134, T. D. 3508, C. B. 11–2, 55); *Weiss* v. *Stearn* (265 U. S. 242, T. D. 3609, C. B. III–2, 51); and *Marr* v. *United States* (268 U. S. 536, T. D. 3755, C. B. IV–2, 116).

and one which does, constitute income to the shareholder within the meaning of the sixteenth amendment to the Constitution is the distinction between a stock dividend which works no change in the corporate entity, the same interest in the same corporation being represented after the distribution by more shares of precisely the same character, and a stock dividend where there either has been a change of corporate identity or a change in the nature of the shares issued as dividends whereby the proportional interest of the shareholder after the distribution is essentially different from his former interest. A stock dividend constitutes income if it gives the shareholder an interest different from that which his former stock holdings represented. A stock dividend does not constitute income if the new shares confer no different rights or interests than did the old—the new certificates plus the old representing the same proportionate interest in the net assets of the corporation as did the old.

Example (1): The X Corporation had an authorized capital stock of $300,000 of common stock, par value $10 a share, and $100,000 of 7 percent cumulative preferred stock, par value $100 a share, which is preferred as to dividends, has no voting rights, and may be redeemed at any time at $105 per share. The articles of incorporation provide that the annual dividend on the preferred stock may be paid in cash or, at the option of the corporation, in one share of common stock for each share of preferred. On July 1, 1936, the X Corporation had outstanding $200,000 of common stock and $100,000 of preferred stock, earnings and